BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. [Redacted]
[Redacted]	)	
	)	DECISION
Petitioners.	)	
	)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination issued by the auditors for the Idaho State Tax Commission (Commission) dated December 12, 2002, asserting additional liabilities for Idaho income tax and interest in the total amounts of $6,745, $22,132, and $22,714 for 1997, 1998, and 1999, respectively.

The auditors made several adjustments to the income of the petitioners. The issues are as follows:

1. The amount of income that should be included in the computation of the petitioners' income from pass-through entities;

2. The amount that should be reported by the petitioners as capital gains;

3. The amount, if any, that should be allowed as a deduction in 1998 and 1999 for passive losses carried forward from prior years;

4. The amount of itemized deductions allowable to the petitioners for each of the years at issue; and

5. The civil fraud penalty.

The auditors made numerous adjustments for each of the years at issue to the amounts reported from pass-through entities in which the petitioners held interests. They increased the amounts reported from the pass-through entities by the amounts of $68,525, $76,672, and $114,741 for 1997, 1998, and 1999, respectively. After the Notice of Deficiency was issued, the petitioners

continued to provide documentation and argument regarding the issues. During the administrative appeal, the issues debated involved the attribution of the purchase price to the various assets in two of the entities. After examining the documentation and discussing the merits, the Tax Commission concedes that the petitioners properly determined the basis of the several assets purchased as [Redacted]. The petitioners have apparently conceded that the auditors had properly determined the correct allocation of the basis of the several assets purchased as [Redacted]. After reflecting these changes, the remaining adjustments regarding the pass-through entities are $67,843, $75,698, and $99,910 for 1997, 1998, and 1999, respectively.

The adjustment to the capital gains and losses reported by the petitioners for 1998 was a reduction in the amount of capital gain reported in the amount of $3,695. The petitioners have not objected to this adjustment.

The auditors disallowed claimed passive activity losses which were carried forward from prior years by the petitioners in the amounts of $68,620 and $32,700 for 1998 and 1999, respectively. The passive losses claimed were from the pass-through entities as follows:

	1998	1999
[Redacted]	$33,343	$32,700
[Redacted]	27,109	
[Redacted]	8,358	
	$68,810	$32,700

There were four grounds for this disallowance. First, the auditors contend that Mr. [Redacted] was a "real estate professional" during the times the passive activity losses were incurred. If Mr. [Redacted] a "real estate professional" during this time, the losses in question were not passive, and therefore should have been deducted in the years incurred rather than being carried forward as passive losses.

The second problem with these losses which were carried forward was that there were mechanical problems with the computations. The Forms 8582 (Passive Activity Loss Limitations) were not filed for all of the relevant years. When this form was filed, sometimes the amounts could be traced from one year to the next. On at least one occasion, the carryover amount was doubled from one year to the next.

The third problem with these losses was that the petitioners did not establish that the expenses allegedly incurred to produce the losses were legitimate, deductible expenditures. Although the review of the prior years was discussed with the petitioners, the records were not made available for review.

In 1997, the petitioners reported net passive income in the amount of $4,265. If there were passive losses to be carried forward, this passive income should have been offset by such losses. For 1997, the petitioners reported nonpassive income from [Redacted] in the amount of $10,102 and nonpassive income from [Redacted] (hereinafter [Redacted]) in the amount of $5,473.

The petitioners contend that the Tax Commission has no right to examine the returns reporting the losses that the petitioners carried forward. The petitioners have cited two cases in support of their position. These are Durrett v. Commissioner, T. C. Memo 1994-179, and Maxwell v. Commissioner, 87 T.C. 783 (1986). Durrett was involved in a tax shelter in the years 1979, 1980, and 1981. The Internal Revenue Service (the Service) mailed a notice of deficiency to the Durretts on April 3, 1984. The case was scheduled for trial before the Tax Court on April 29, 1993. On April 21, 1993, the Durretts moved to amend their petition to raise for the first time an investment tax credit carryback from 1983 to 1980. In denying the Durretts' motion to amend, the Tax Court set out that a party may amend a pleading at any time before a responsive pleading. Otherwise, a party may amend a pleading only by leave of the Court or by written consent of the adverse party.

The motion was not filed before the responsive pleading and the Durretts had not obtained the consent of the adverse party. The Court stated that, "[t]he motion is addressed, therefore, to the sound discretion of the court." The Court further stated, in part [cited by the petitioner herein]:

> "Furthermore, even if respondent's files concerning the partnership were available, a reconstruction of 10-year old transactions would be difficult, if not impossible, and prejudice to the other party is manifest."

In the Durrett decision, the Court also stated:

> This Court has long held that we have jurisdiction to consider the claim of an investment tax credit carryover or carryback to a year that is before this Court where the credit arises in a year that is not before this Court and would otherwise be barred by the period of limitations. Hill v. Commissioner, 95 T.C. 437 (1990); Mennuto v. Commissioner, 56 T.C. 910, 923 (1971); Brock v. Commissioner, T.C.Memo. 1982 335; see also Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 439 441 (1974), affd. without published opinion 510 F.2d 970 (3d Cir.1975) (same with regard to net operating loss carrybacks and carryovers). This is true even if it would involve recomputing the tax liability in the other year to determine whether credit could be carried back or over. Hill v. Commissioner, supra at 441 442. Respondent argues that there is nothing in either the statutory framework of the TEFRA provisions or its legislative history indicating that Congress intended to repeal section 6214(b) and the case law based thereon. We agree. (Footnote omitted.)

The other case cited by the petitioners is Maxwell v. Commissioner, *supra*. In this case, after a fruitless period of trying to negotiate a settlement, the Service issued a notice of deficiency to the Maxwells disallowing a loss and investment tax credit which was passed through from a partnership in which they held an interest. The Maxwells appealed indicating that the Service had no authority to assess to them (as partners) a deficiency attributable to a partnership item until after the close of a partnership proceeding.

In Maxwell, *supra*, (cited by the petitioners) the government's deficiency was challenged by the taxpayers on procedural grounds. The Service issued their statutory notice to the partner

(Maxwell) without first issuing a "final partnership administrative adjustment" to the partnership. The Court found that this procedure was flawed and therefore found that the Court had no jurisdiction over the case. The Commission finds that this case is inapposite since the state of Idaho didn't adopt the uniform audit procedures (§ 6221 et seq. of the Internal Revenue Code) upon which Maxwell turns.

Idaho Administrative Rule 200 stated, in part:

> EXAMINATION OF BOOKS AND WITNESSES AND DISCOVERY (Rule 200). Sections 63 3042 and 63 3043, Idaho Code. (3 20 97)
>
> 01. Retention Of Working Papers. Each taxpayer shall retain and make available on request all business records and working papers used in the preparation of, or relevant to the correctness of, any tax return subject to examination by the Tax Commission.

Net operating losses are, in many ways, similar to passive activity losses. The Tax Court has previously addressed whether the government may determine the amount of a net operating loss in a year not at issue in the process of computing the amount of a deduction for a year which is at issue:

> It is well settled that we may determine the correct amount of taxable income or net operating loss for a year not in issue (whether or not the assessment of a deficiency for that year is barred) as a preliminary step in determining the correct amount of a net operating loss carryover to a taxable year in issue. ABKCO Industries, Inc., 56 T.C. 1083, 1088-1089 (1971), affirmed on another issue 482 F.2d 150 (C.A. 3, 1973), and cases cited therein. See also Anthony Mennuto, 56 T.C. 910, 923 (1971), involving the analogous determination of an investment credit carryover, and cases cited therein.

Lone Manor Farms. Inc. v. Commissioner, 61 T.C. 436, 440 (1974), affd. without published opinion 510 F.2d 970 (3d Cir. 1975).

In another case the Tax Court also addressed the burden of proof for carryovers as follows:

> Petitioners, however, have presented no credible evidence and have not established the existence of, nor their entitlement to, any of the claimed carryovers. Petitioners and their counsel appear to seriously misunderstand the placement of the burden of proof on these issues. For example, with regard to the investment interest carryover, the following statement appears in petitioners' opening posttrial brief --
>
> respondent did not recompute or establish the proper investment interest amount, and [respondent is] therefore estopped from asserting that it may not be carried forward.
>
> To the contrary, with regard to each of the claimed carryovers, petitioners have the burden of proof, and they have failed to satisfy it. Hill v. Commissioner, 95 T.C. 437, 439 444 (1990); Lone Manor Farms, Inc. v. Commissioner, *supra.*

Leavell v. Commissioner, T. C. Memo 1996-117.

The Idaho Supreme Court has also addressed the issue of examining years which were closed for the purpose of issuing a notice of deficiency to redetermine the proper amount of a deduction in an open year. In Harmon's of Idaho v. Idaho State Tax Commission, 114 Idaho 740, the Court addressed a matter in which the taxpayer had taken the full amount of net operating losses forward, while the law provided that the net operating loss must have been carried back to the previous three years before the remaining balance could be carried forward to subsequent years. The auditor reduced the net operating loss carryforward to reflect the amount of the net operating loss that should have been applied to the years prior to the year of the loss. The Idaho Supreme Court upheld that adjustment.

Since the petitioners reported net passive income on their 1997 income tax return which was not offset by the purported passive activity losses carried forward, it would appear that the petitioners for one reason or another had determined that they did not have available losses to be carried forward to 1997. Yet in 1998 and 1999, they found that they had losses from years prior to 1997 that were available to be carried forward to those years.

Additionally, both [Redacted] and [Redacted] reported nonpassive income in 1997. If these entities were not passive activities in 1997, what were the differences in the operation of those entities in prior years that would cause them to be classified as passive in those years?

The Commission finds that the petitioners have not carried their burden of establishing that the losses here in question existed. Therefore, the Commission need not address whether Mr. [Redacted]was a "real estate professional."

The auditors made three adjustments to the itemized deductions claimed by the petitioners. These adjustments were to the mortgage interest, investment interest, and to charitable contributions.

There are several pieces of information regarding the allowable amount of mortgage interest which the petitioners have not provided. The missing information includes the following:

1. The amount, if any, of the initial mortgage at the time of the purchase;

2. The cost of improvements to the property; and

3. How the improvements were characterized when paid.

The burden of proof with regard to deductions is upon the taxpayer. New Colonial Ice Co., Inc. v. Helvering, 54 S. Ct. 788, 790 (1934). Therefore, the deduction may be limited to the facts that the petitioners have established.

Even though some of the facts have not been established, the Commission has found that there were certain computational problems with the determination of the allowable mortgage interest deduction. The Commission finds that the petitioners are entitled to a higher deduction than was determined in the notice of deficiency. The Commission finds that the petitioners should be allowed deductions for mortgage interest in the amounts of $14,830, $20,317, and $22,542 for 1997, 1998, and 1999, respectively.

The petitioners did not supply additional information or argument during the administrative appeal with regard to the adjustment to their deduction for investment interest. Therefore, the Commission finds that the auditors' adjustments should be affirmed.

The auditors also made adjustments to the petitioners' claimed deductions for charitable contributions. The auditors made adjustments to the amounts claimed by the petitioners as in-kind contributions. They assigned values to the items listed as donated that were different than those so assigned by the petitioners. However, also at issue is whether the lists of items donated are accurate. In many of the instances questioned by the petitioners, the list of items donated was not completed by the charitable organization and was not affirmed in any way by the charitable organization. In considering the entire matter, the Commission finds that the petitioners have not carried their burden of proof in establishing that the value of the items donated exceeded those amounts allowed by the auditors. Therefore, the auditors' adjustments to the charitable contribution deductions are hereby affirmed.

Pursuant to Idaho Code § 63-3046(b), the civil fraud penalty was asserted by the auditors. Information in the files indicates numerous instances which appear to constitute fraud on the part of Mr. [Redacted]. Most of those involve expenditures on behalf of pass-through entities which were claimed as business expenses that appear to be personal expenses or payments for business entities other than the one from which the funds were taken. In many of these instances, the auditors interviewed the vendors. The vendors repeatedly indicated that the expenditures characterized as business expenses were actually for the petitioners' personal residence. The evidence of fraud is voluminous. While the petitioners have indicated that they do not agree with the imposition of the penalty, they presented nothing to rebut the auditors' allegations. The Commission finds that the fraud penalty was properly asserted. Accordingly, the Commissions affirms this penalty.

WHEREFORE, the Notice of Deficiency Determination dated December 12, 2002, is hereby MODIFIED and as so modified is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax, penalty, and interest (calculated to June 30, 2005):

YEAR	TAX	PENALTY	INTEREST	TOTAL
1997	$ 3,124	$1,562	$1,553	$ 6,239
1998	11,756	5,878	4,936	22,570
1999	11,601	5,801	4,027	21,429
			TOTAL DUE	$50,238

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' right to appeal this decision is enclosed with this decision.

DATED this _____ day of_____, 2005.

IDAHO STATE TAX COMMISSION

_____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2005, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in envelopes addressed to:

[Redacted] _____